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In the Supreme Court of the United States

OCTOBER TERM, 1945.

No. 456

TESTAMENTARY TRUST u/w OF SAMUEL MATHER,
Deceased,
William G. Mather and S. Livingston Mather,
Trustees,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI
To the United States Circuit Court of Appeals
for the Sixth Circuit
and
BRIEF OF PETITIONER.

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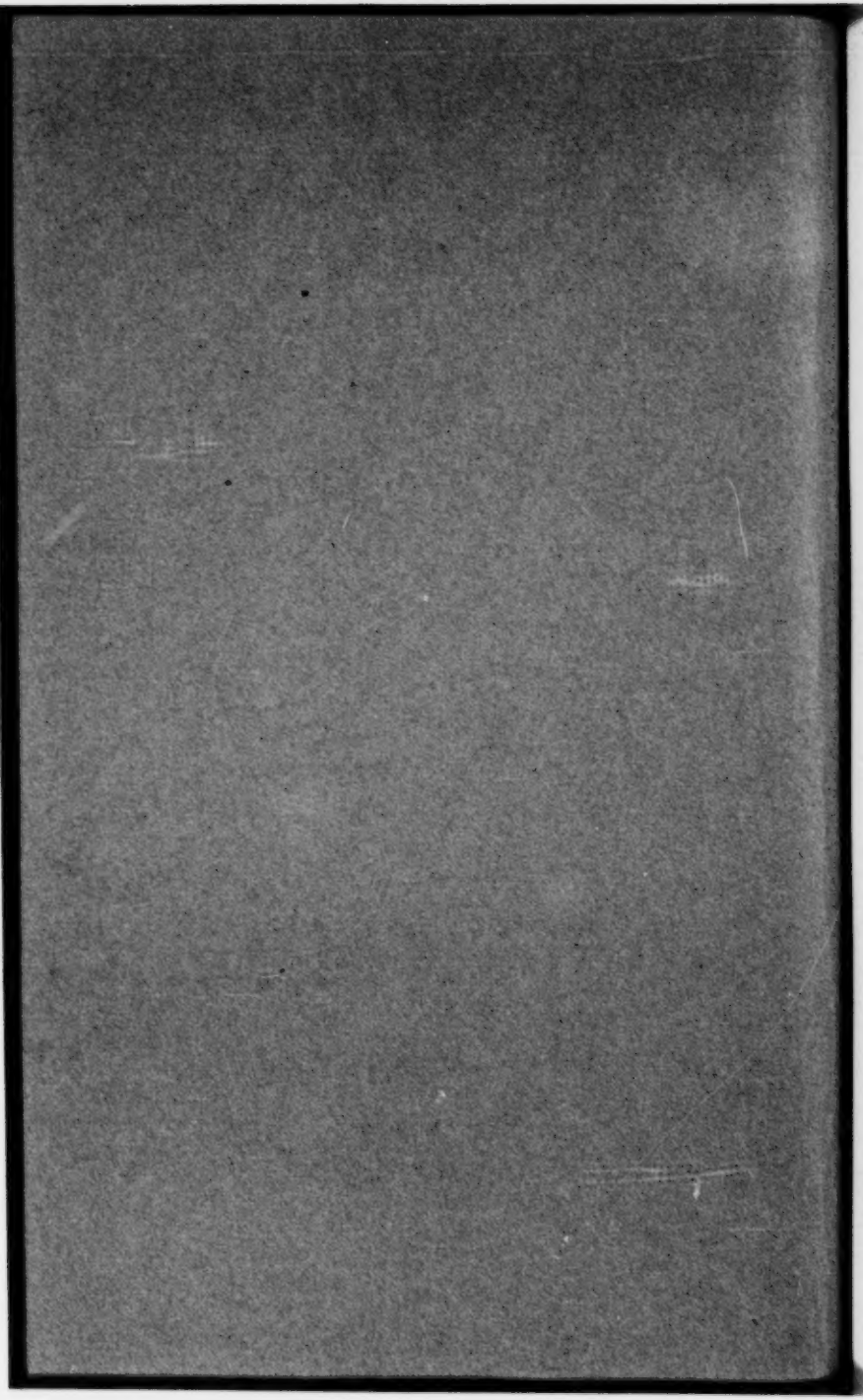

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PETITION FOR WRIT OF CERTIORARI
To the United States Circuit Court of Appeals
for the Sixth Circuit.

To the Honorable, the Chief Justice and the Associate Justices of the Supreme Court of the United States:

Petitioner prays that a writ of certiorari issue to review the judgments of the Circuit Court of Appeals for the Sixth Circuit entered in this case on May 23, 1945 and July 2, 1945, respectively. Said judgment entered on May 23, 1945, affirmed the judgment of the Tax Court of the United States in favor of respondent and against petitioner relating to petitioner's federal income tax liability for the year 1939. Said judgment entered on July 2, 1945, denied petitioner's petition for rehearing and reargument of this case.

* This case involves substantially the same facts and the same issues as those involved in S. Livingston Mather v. Commissioner in which a petition for a writ is being concurrently filed.

JURISDICTION OF THE COURT.

The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925 (43 Stat. 938; U. S. C., Title 28, Section 347 a) and Section 1141 of the Internal Revenue Code (53 Stat. 154; U. S. C., Title 26, Section 1141).

STATUTE INVOLVED.

The statute involved is Section 23 (k)(1) of the Internal Revenue Code, the relevant part of which reads as follows:

> "Sec. 23. In computing net income, there shall be allowed as deductions:
>
> * * * * *
>
> (k) Bad Debts.—
>
> (1) General Rule.—Debts which become worthless within the taxable year; * * *"

STATEMENT OF THE MATTER INVOLVED.

The facts are all stipulated. They show, and it is conceded, that during 1939 petitioner paid from its own funds approximately $49,000 on its accommodation obligation on a promissory note to Cleveland banks on which Robert H. Bishop, Jr., was the primary obligor; that a debt from Bishop to petitioner arose from such payments; that at the time the accommodation obligation was undertaken "no gift was made or intended"; that during 1939 Bishop was insolvent and unable to pay anything on any unsecured obligation; and that petitioner took a deduction in its income tax return for 1939 for the debt from Bishop to it which thus arose and became worthless in that year.

Petitioner's apparent right (under the provisions of Section 23 (k)(1) above quoted) to a deduction for such worthless debt was, however, denied by the Tax Court and the Circuit Court because they said that the stipulated

facts were the substantive equivalent of a theoretical situation under which petitioner would not itself have made such payments or acquired such debt and that petitioner's right to such deduction must be controlled by such theoretical substantive equivalent of the stipulated facts.

The following background facts, which were stipulated without question as to their actuality, are also involved in the issue:

Petitioner is a testamentary trust created under the will of Samuel Mather, deceased (herein called "Mather") for the benefit of his granddaughter. Prior to June 1, 1931, Robert H. Bishop, Jr. (herein called "Bishop"), Mather's son-in-law, maintained certain brokerage accounts. During the period from September 29, 1930 to April 14, 1931, Mather loaned Bishop various securities which were used by Bishop to collateralize his indebtedness under such accounts. (R. 43-45.)

On June 1, 1931, Mather, for the accommodation of Bishop, joined with Bishop in executing and delivering to The Guardian Trust Company of Cleveland, Ohio, a note (herein referred to as the "Accommodation Note") in the principal sum of $3,566,000. The entire proceeds of this note were disbursed by The Guardian Trust Company in payment of Bishop's indebtednesses. (R. 43-45.) It was collateralized by securities belonging to Bishop, securities loaned to Bishop by his wife and securities loaned to Bishop by Mather. Such collateral had an approximate market value on June 1, 1931 of $4,650,000, of which $2,250,000 was attributable to the collateral owned by Bishop and his wife. (R. 46.)

It is expressly stipulated and found that at the time Mather loaned his securities to Bishop and at the time the Accommodation Note was given, the circumstances and conditions were such that no gift was made or intended to be made by Mather. (R. 46, 47, Stip. par. 4; Tax Court Findings R. 176.)

Mather died testate October 18, 1931. He owed other large obligations besides that on such Accommodation Note. His Executors made some small payment on the Accommodation Note, but as the depression continued it became obvious that the liquidation of the estate would be disastrous to both the estate and its creditors. To avoid such disastrous liquidation the Executors, legatees, creditors and Bishop and Mrs. Bishop entered into the so-called "Creditors Agreement" of November 13, 1933. (Stip. Ex. K, R. 81.)

Pursuant thereto (a) Samuel Mather Estate, Inc., an Ohio corporation (herein called the "Estate Company"), was "duly" organized; (b) all of the assets of the estate were "duly transferred" to the Estate Company; (c) the Estate Company fully assumed all of the liabilities of the estate; (d) the Executors and estate were released and discharged from such liabilities; (e) the Estate Company issued all of its common stock, Class A preferred stock and Class C preferred stock to the Executors; (f) the Estate Company then entered into a mortgage and contract with the creditors, Bishop, etc., providing among other things for an extension of time for payment of the Accommodation Note and other obligations for a period of five years from December 31, 1934; (g) a formal contract was entered into by Bishop, Mrs. Bishop and others confirming his primary obligation on the Accommodation Note and to repay with interest any amounts paid thereon by the Executors, Estate Company or successors; and (h) the Executors shortly disposed of certain shares of the Class A preferred stock to take care of certain cash bequests under Mather's will, distributed their remaining shares in the Estate Company in satisfaction of the other bequests, filed their final accounts and were discharged, and the estate was closed. (Stip. Ex. K, and Stip. pars. 10, *et seq.;* R. 81, *et seq.* and 49 *et seq.*)

The transaction between the Executors and the Estate Company was a tax-free reorganization upon which no gain or loss was recognized for federal income tax purposes. (Stip. par. 22, R. 52.)

By the formal contracts Bishop and his wife, in addition to confirming his primary obligation on the Accommodation Note, agreed that their securities pledged therefor should be sold first, and Mrs. Bishop also pledged, as additional security for past and future obligations of Bishop for any accommodation payments made on the note, 1,000 shares of Class C preferred stock of the Estate Company received by her on distribution from the Executors. (R. 52, 171-174.)

On the final distribution from the Executors petitioner received one-sixteenth of the Class C preferred stock and one-sixteenth of the common stock of the Estate Company, to wit: 250 and 62½ shares, respectively. (R. 50, 51.)

Thereafter and until 1938 the Estate Company conducted its business, disposed of assets and made payments on debts, modified its mortgage and other contracts and made certain changes in its capital structure disclosed by the record. The reality and actuality of neither its existence, its ownership of its assets, its obligations to its creditors or its corporate relations to its stockholders were ever questioned by the Commissioner; and nothing in the stipulated record throws any doubt thereon. Neither did the Commissioner question, nor does anything in the record throw any doubt upon, the actuality of the fact that shortly after the organization of the Estate Company Mather's estate was wound up and the Executors discharged.

The Estate Company was a personal holding company heavily in debt. The taxation of such companies under the Internal Revenue Laws became increasingly burdensome so that Congress included in the Revenue Act of 1938, Section 112 (b)(7) for the liquidation of such corporations without excessive tax.

It is expressly stipulated:

> "In December, 1938, said Samuel Mather Estate, Inc. was completely liquidated under and pursuant to a plan of complete liquidation *duly* adopted and carried out by it and *its shareholders* in accordance with the provisions of Section 112 (b)(7) of the Revenue Act of 1938." (Stip. par. 16, R. 50.)*

In connection with such liquidation petitioner, which still retained its Class C preferred stock and common stock, received in kind its pro rata share of the assets of the Estate Company; and,

> (a) *By formal contract with the Estate Company and its secured creditors* (including the holders of said Accommodation Note) petitioner assumed and agreed to pay *without limitation* one-sixteenth of the balance remaining unpaid on the Accommodation Note (which one-sixteenth amounted to $87,732.19) and on the other secured obligations of the Estate Company (Ex. I to Stip., R. 116, 119, par. A); and
>
> (b) *By another agreement* with the Estate Company it *also* agreed to pay one-sixteenth of each other debt or obligation of the Estate Company but only out of the assets distributed to it. (R. 51, 52, 114, 108.)

By September 15, 1939, all of such remaining obligation on the Accommodation Note had been fully paid,—something over $38,000 having been paid through the exhaustion of the remaining Bishop collateral and the balance (approximately $49,000) being paid by petitioner from its own funds during the year 1939. (R. 52.)

It is expressly stipulated that the Plan of Liquidation and the agreements in connection therewith were "*duly* adopted and carried out" and that the transfers of assets to petitioner and the other *stockholders* in accordance therewith were "*duly*" made. (Stip. pars. 16, 18, 19, 20; R. 50-52.)

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* Emphasis throughout this petition is ours.

At that time Mather's estate had been closed and his Executors had been discharged many years previous. Neither in denying the bad debt deduction claimed, nor in making the stipulations, nor before the Tax Court, *did the Commissioner ever question the reality or actuality of these stipulated transactions; and nothing in the record throws the slightest doubt thereon.*

Throughout the year 1939 Bishop was insolvent and unable to pay any amount of any unsecured obligation owed by him. (R. 47.)

In its income tax return for the year 1939, petitioner claimed as a deduction the worthless debt which thus arose and became owing to it by Bishop on account of the payments made in such year by the petitioner on the Accommodation Note. (R. 22.)

The Commissioner denied such deduction. Petitioner filed a petition in the Tax Court to review such determination. In that Court the Commissioner did not question the actuality of the stipulated facts but attempted to sustain his determination principally on two grounds: (1) that Mather's was not an accommodation obligation; and (2) because, in the settlement of Mather's estate tax, an amount equal to the difference between the face amount of the Accommodation Note and the then value of the Bishop collateral had been deducted in estimating the date of death value of the net estate.

Being obviously unable to sustain the Commissioner's determination on such grounds, the Tax Court, nevertheless, did sustain such determination by finding that, under a customary administration of Mather's estate under Ohio law, his Executors would have liquidated the assets, paid the debts and distributed the net residue; that, while this was not done, the net effect on what was done was the same as if the estate had been administered in a customary manner; that "petitioners can claim no different position than that of residuary legatees of such estate"; that peti-

tioner was not in the position of an assignee; that its payments were purely voluntary and that no bad debt deduction would be allowed "under the circumstances." It entered an order determining a deficiency in petitioner's income tax liability for 1939 in the amount of $6,466.67.

Upon appeal, the Circuit Court affirmed the Tax Court's decision, basing its conclusion more clearly and exclusively on such application of the "rule of substance," as under the stipulated record there was, of course, no factual support for the theory that petitioner was a mere volunteer and it was conceded that a debt from Bishop to it did arise from such payments.

It is to obtain a review of such judgment of the Circuit Court of Appeals that a writ of certiorari is hereby sought.

QUESTION PRESENTED.

Is petitioner to be denied a bad debt deduction allowed by the simple, unconditional provisions of Section 23 (k) (1) of the Internal Revenue Code merely because the transaction from which the same arose was deemed by the Court below to be the substantive equivalent of some other transaction (admittedly not carried out) from which no such deduction would have arisen, although the actuality of the facts giving rise to the deduction was never questioned by the Commissioner and is fully confirmed and established by the stipulated record?

REASONS RELIED UPON FOR THE ALLOWANCE OF THE WRIT.

First: The Court below has decided a federal question in a way in conflict with the applicable decisions of this Court in *Eisner v. Macomber*, 252 U. S. 189, and *United States v. Phellis*, 257 U. S. 156, in that the Court below in regarding the "substance of the thing done" has disregarded the "essential truth disclosed" by the stipulated record and substituted therefor a theoretical, substantive

equivalent though expressly finding that such equivalent was not "done".

Second: The decision of the Court below is in conflict with the decisions of the Circuit Court of Appeals for the Fourth Circuit in *Henrietta Mills, Inc. v. Commissioner*, 52 Fed. (2d) 931, and *McDonald v. Commissioner*, 52 Fed. (2d) 920, in that the Court below, in "looking through the form" of what was done, disregarded the "essential truth disclosed" by failing to give substance and effect to the stipulated existence of a corporation and its "duly" effected acquisitions and dispositions of the property, and by substituting therefor a theoretical continuance of operations by Executors of an estate, though on the stipulated record and findings the Executors had been discharged and the estate closed by order of the probate court years before.

Third: The decision of the Court below (except for its disregard of the actualities and its creation of a fictitious substance of the "thing done") is in conflict with the decision of the Circuit Court of Appeals for the Second Circuit in *Shiman v. Commissioner*, 60 Fed. (2d) 65, in that it disallows the deduction of the worthless debt from Bishop to petitioner which in fact arose when petitioner paid its own money on the accommodation obligation previously undertaken in a transaction not involving any donative intent; and with the decision of the Circuit Court of Appeals for the Third Circuit in *Commissioner v. Breyer* and four companion cases decided August 31, 1945 (not yet officially reported; but see C. C. H. 1945 Federal Tax Service, par. 9398) in that it treats a transferee taxpayer on a different basis from other taxpayers, although the language of the statute providing for the deduction in issue does not require or justify any different treatment.

PRAYER.

Wherefore petitioner respectfully prays that a writ of certiorari issue to the Circuit Court of Appeals for the Sixth Circuit requiring that Court to certify and send to this Court for its review and determination a full and complete transcript of the record and all proceedings in the case numbered and entitled on its docket "No. 9915—Testamentary Trust u/w of Samual Mather, Deceased, William G. Mather and S. Livingston Mather, Trustees, Petitioner, v. Commissioner of Internal Revenue, Respondent" and that the judgment of said Circuit Court of Appeals be reversed by this Court.

Petitioner's brief in support of its petition is annexed hereto.

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